United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7008

UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket No. 75-7008

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P/S

STUART A. JACKSON,

Plaintiff-Appellant,

v.

JACK OPPENHEIM,

Defendant-Appellee.

~~ANSWERING~~ BRIEF OF PLAINTIFF-APPELLANT

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15 U.S.C. § 77k:

> "(e) . . . In any suit under this or any other section of this subchapter the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard."

15 U.S.C. § 77l:

"Any person who--

> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket No. 75-7008

STUART A. JACKSON,

Plaintiff-Appellant,

-against-

JACK OPPENHEIM,

Defendant-Appellee.

BRIEF OF PLAINTIFF-APPELLANT

ISSUES PRESENTED

1. Did defendant sustain his burden of proof that he could not have known of the omission of material information if he had exercised reasonable care (Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2))?

2. Was the trial court's award of attorney's fees to defendant proper?

PROCEEDINGS BELOW

This action was commenced by plaintiff, Stuart A. Jackson ("plaintiff") by filing a complaint on March 16, 1971 (A.4)* seeking rescission of a stock purchase agreement for alleged violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Defendant-Appellee Jack Oppenheim ("defendant") served an answer with a counterclaim (A.9) based on two promissory notes representing the balance of the purchase price for such stock and seeking interest on the notes at the contract rate of 9-1/2% per annum until the date of judgment, as well as an award of attorney's fees based on a provision in the notes.

The trial was commenced before the Honorable Charles H. Tenney sitting without a jury on September 11, 1974 and was concluded on September 12, 1974. Judge Tenney filed an opinion on November 21, 1974 (A.29) denying the relief requested by the plaintiff on both counts and granting judgment to the defendant on the counterclaim in the amount of $33,852. In addition, Judge Tenney awarded costs and fees to the defendant with

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* All material appearing in the Joint Appendix is cited by reference to the page of the Appendix at which said material is reproduced (e.g., "A.__") except that citations to exhibits are cited by both the exhibit number and the page of the Exhibit Volume (e.g.,"Ex.__, E.__").

an order to the parties to submit papers regarding the determination of the costs and fees within ten days. On December 18, 1974, plaintiff filed notice of his appeal from the opinion of the Honorable Charles H. Tenney. Subsequently, Judge Tenney filed a memorandum decision on October 7, 1975 (A.52) granting to defendant costs and attorney's fees in the amount of $12,850 from which plaintiff also appeals.

STATEMENT OF FACTS

Chelsea House Communications, Inc. (the "Company") is a New York corporation which was organized November 3, 1966 to succeed to the business conducted by a general partnership formed in January 1966. The Company was at all times relevant engaged in the publication of books and production of films for sale primarily to libraries, colleges and schools and the publication of hard cover books for the consumer market (Ex.2, p.3, E.14, 18).

The plaintiff is an attorney and a member of the firm of Rogers & Wells of New York City which was retained by the Company in April 1969 to assist in the preparation of a registration statement for a proposed public offering of the Company's shares (A.491). In June 1969 Harold Steinberg, President and one of the founders of the Company, in contemplation of the public offering, requested plaintiff to become Secretary and a director of the Company (A.496-97, 171-72). Plaintiff agreed to accept these positions on the condition that he would not become in-

volved in the day-to-day operations and management of the Company but would assume the posture of an outside director similar to that enjoyed by Arthur Schlesinger, Jr., the only other outside director (A.172-73). Plaintiff was elected to these positions on June 13, 1969.

The defendant is also an attorney and one of the founders of the Company, first as a partner of the predecessor partnership, and subsequently as an organizer and a principal stockholder of the Company (A.383-85). Defendant served continuously as Vice-President and a director from 1966 until his resignations as Vice-President on March 6, 1970 and director on April 10, 1970 (A.385-86). Defendant continued to maintain his office at the Company until April 10, 1970.

Pursuant to an agreement dated April 7, 1970, plaintiff purchased from defendant on April 10, 1970, 14,618 shares of common stock of the Company for $43,854. Plaintiff paid $10,000 at closing and the balance was evidenced by two promissory notes, each in the amount of $16,926 payable on April 10, 1971 and April 10, 1972, respectively (Ex.H, E.221, 229).

Ten other individuals, three of whom were not connected with the Company, purchased the remaining 131,565 shares owned by the defendant for an aggregate purchase price of $394,695 (Ex.H, E.221, 229).

In July 1970, less than three months after plaintiff's purchase, the Company filed for reorganization under Chapter XI of the Federal Bankruptcy Act (A.101).

Management Structure of the Company

From June 13, 1969, the date of plaintiff's election as a director and Secretary, through April 10, 1970, the date of plaintiff's purchase, the Company was managed and operated by an inside management group consisting of Harold Steinberg, President; Andrew Norman, a Vice-President and Controller; Jeffrey Steinberg, a Vice-President; Leon Friedman, an attorney who served as house counsel; Robert Hector, the Chairman of the Board; Fred Israel, an employee who was also a director; and the defendant, Jack Oppenheim, who was a Vice-President (A.388-90).*

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* Norman, Steinberg, Hector and defendant controlled the Company. Prior to defendant's sale of his stock in April 1970, Norman owned 30% of the stock of the Company and defendant, Hector and Steinberg each held slightly over 20% (A.385, 389).

During this period, the Company held no meetings of the Board of Directors or stockholders of the Company (A.390, 440). Management decisions were made by this inside group at almost daily meetings held at the Company's offices. Defendant regularly participated in these meetings (A.390-93). The Company's day-to-day legal affairs during 1969 and 1970 were handled by Leon Friedman, its house counsel (A.441-42).

Defendant Oppenheim was actively involved in the day-to-day operations of the Company for which he was paid a salary of $18,000 a year which was increased to $25,000 a year in October 1969 (A.387-88). As a senior officer of the Company, defendant's function was to supervise projects undertaken by the Company (A.387-88).

Plaintiff Jackson was unsalaried and was not involved at any time in the day-to-day management of the Company (A.513). He was never requested to perform any services as Secretary or as a director of the Company and was never invited to attend any of the management meetings of the Company (A.391-92, 412, 508-09, 173).

In 1969 plaintiff's activities on behalf of the Company were limited to introducing the Company to Herzfeld & Stern, a potential underwriter (A.167-70); attending several

meetings with representatives of Herzfeld & Stern and Herbert Young & Company, another underwriter, in connection with a proposed public offering of the Company's securities (A.169-71, 178-79); introducing the Company to Price Waterhouse & Co., an accounting firm retained by the Company (A.174-76); representing the Company in a single litigated matter in an action for breach of contract arising out of the purchase of a film library (A.178); and review of the July 1969 Registration Statement (A.173-74, pp. 8-9 infra). In 1970 (prior to April 10), plaintiff's efforts on behalf of the Company were limited to introducing the Company to E. L. Aaron & Co., another underwriter (A.294-96).

The Company did not prepare monthly balance sheets or monthly profit and loss statements (A.400-01, 453-54). Except for the financial statements contained in the Registration Statement filed in July 1969 (Ex.C, E.148),* and an audited statement for the year ended October 31, 1969 (Ex.B, E.139), the Company did not issue any other financial statements or other written reports of operations prior to April 10, 1970, the date upon which plaintiff purchased defendant's shares (A.400-01, 453-54, 179-82).

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* The latest financial statements included in the prospectus were for the six months ended April 30, 1969 (Ex.C, pp. 19-25, E.148, 166-72).

The Company's Efforts to Sell its Stock

The Company filed a Registration Statement with the Securities and Exchange Commission on July 29, 1969 covering the proposed sale of 200,000 shares of its common stock at $10 per share without the aid of an underwriter (Ex.2, E.14). Plaintiff's law firm acted as attorneys for the Company in connection with the preparation and filing of the Registration Statement (A.173-74).

In July 1969, management including defendant was "extremely optimistic" about the future of the Company (A.395-96). Indeed, when the underwriter demanded that the Company lower the offering price of the stock from $10 to $7 per share, defendant concurred in management's decision to go forward with the offering at $10 per share without an underwriter (A.397-98).

In the fall of 1969, in response to a letter of comment from the Securities and Exchange Commission, one of plaintiff's associates prepared a revised Registration Statement and forwarded it to the Company's management for review (A.155-56). No comments were forthcoming and no amended Registration Statement was filed (A.157). After

October 1969, plaintiff's firm rendered no further legal services in connection with the pending Registration Statement which was allowed to lapse in January 1970 (A.296-97).

In late 1969, defendant had been active in negotiating a private exempt offering of the Company's stock through Bache & Company. Bache was interested as a result of management's projection of a $100,000 profit for the year ended October 31, 1969. Bache withdrew when the audited figures became available in late January 1970 showing a $30,000 loss (A.399). For the first time, defendant testified, his confidence in management "really became shaken" because management had no answer to the disparity -- more than three months after the year end -- between management's projection and the actual figures (A.399). Defendant, however, conceded that he did not bring this problem to the attention of the outside directors, plaintiff and Arthur Schlesinger, Jr. (A.399-400).

After January 1970, the Company discussed the possibility of a public offering only with one underwriting firm which indicated an interest in lending its name to a "best efforts" underwriting provided the Company supplied purchasers for the entire issue (A.294-96).* Plaintiff

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* A "best efforts" underwriting obligates the underwriter to purchase from the company only such shares as he is able to sell to the public (A.295-96).

discussed this proposal with the President of the Company and advised against incurring the expense of preparing a new Registration Statement as it appeared that the underwriter's terms probably could not be satisfied (A.296-98). Moreover, the market for the public sale of new issue securities had continued to deteriorate through early 1970 (A.298-99). Plaintiff's advice was accepted and no new Registration Statement was ever prepared (A.298).

Plaintiff and defendant knew that the market for new issues was poor and that the Company's continuing efforts in 1969 and 1970 to interest underwriters and investment bankers in making a public sale of its securities were unsuccessful. Both plaintiff and defendant were aware that the Company was continuing to meet with prospective underwriters during this period with a view toward making a public offering of its securities but at no time after January 1970 was anyone optimistic about the possibility of doing so (A.297-99).

March 13, 1970 Meeting Between Plaintiff and Defendant

On March 13, 1970, defendant was at plaintiff's offices pursuant to an appointment with another attorney in plaintiff's firm on a matter not relevant to this appeal (A.136). Upon impulse and without a prior appointment,

defendant visited with plaintiff for approximately fifteen minutes to a half hour (A.417-18). He advised plaintiff that he was frustrated artistically by the President of the Company, Harold Steinberg, and that defendant's ideas for the development of the Company were disregarded (A.186-88).

Defendant asked plaintiff to speak to Steinberg on his behalf. Plaintiff responded that he knew nothing about the business of the Company or the nature of the defendant's problem with Steinberg. He agreed, however, to help to the extent of speaking to Mr. Norman, another principal stockholder of the Company for whom the plaintiff had great respect, if Mr. Norman called him (A.187-88).

During the course of the meeting, defendant did not disclose to plaintiff that the financial condition of the Company was deteriorating or that bankruptcy was imminent (A.436-37, 192-93). On the contrary, defendant advised plaintiff that, notwithstanding his personality problem wit.. Mr. Steinberg, defendant was optimistic about the prospects of the Company (A.281).

As of March 13, 1970, the date of the meeting, defendant had not decided to sell his stock nor had plaintiff been asked to purchase any stock (A.447, 479-80).

Defendant Omitted to Disclose Material Adverse Information

In the latter part of March 1970, plaintiff received a telephone call from Steinberg seeking his advice as to whether or not there were any legal problems in connection with a possible purchase by Steinberg and others of defendant's stock. In the course of the conversation Steinberg, in response to plaintiff's inquiry, advised him that things were going well with the Company and that everything was fine. In the course of the same conversation, plaintiff agreed to purchase some of defendant's shares (A.509-12, 195-96).

In agreeing to purchase defendant's shares, plaintiff relied upon the favorable comments made by Steinberg, the chief executive officer of the Company, the optimistic reports which he received from defendant at their March 13, 1970 meeting, and the information that he had obtained from his review of the Registration Statement prepared and filed for the Company in July 1969 and the subsequent Company year-end financial statement dated October 31, 1969 (A.200-01).

Shortly after the March 13 meeting between plaintiff and defendant, defendant prepared an eleven-page memorandum

detailing certain adverse facts about the Company (Ex.1, E.1). This memorandum, which had taken defendant more than a week to compose, was delivered to Robert Hector, Chairman of the Board of the Company, and several other members of management (A.423-24, 434).

The memorandum (Ex.1, E.1) detailed certain material facts which were unknown to the plaintiff prior to his purchase of the defendant's shares: (a) the Company was going through a period in which the question of its survival might be at stake (E.1); (b) current liabilities exceeded current assets by over $500,000 (E.1); (c) the Company was completely mismanaged in several material respects and had no plan to meet the then emergencies (E.1); (d) creditors were pressing and were not being paid (E.7); and (e) circumstances could shortly force the Company into bankruptcy (E.5). The memorandum is discussed in greater detail in the argument section in connection with the trial court's holding that certain of the information discussed therein was material (pp. 19-21, infra).

Defendant never disclosed to plaintiff that the memorandum had been written. He did not give a copy to the plaintiff nor did he discuss the contents of the memorandum

with plaintiff. Defendant did not know nor did he attempt to ascertain whether plaintiff had received a copy of the memorandum or whether plaintiff was aware of the facts therein (A.411-12, 423-24, 443, 447, 449, 462, 468-72, 330-31). Prior to plaintiff's purchase of defendant's shares, he had not received a copy of the memorandum prepared by the defendant nor did he know of its existence or the facts contained in the memorandum (A.197-99, 330-31).

Defendant also failed to disclose to plaintiff that the Company was in serious financial difficulty because of the failure of its current book sales. Defendant testified that the Company's Christmas list of trade books which was put on sale for the fall and winter of 1969-70 was "very critical" as one of the major sources of revenue for the Company (A.405-10). Defendant knew that the Christmas book list was not selling and that there was a substantial imbalance in the Company's account with Random House. The Company financed the production and distribution of its trade books through advances from Random House which were to be repaid from the proceeds of the sales of the books. Advances were received in February and early March 1970 on many big new projects although the Company was not generating sufficient revenues from its book sales to repay prior advances from Random House (A.455-56).

Plaintiff was not aware of the disappointing results of the Random House Christmas list, nor did plaintiff know the status of the account between Random House and the Company, which facts were known to the defendant and other insiders of the Company (A.408-11, 419-20, 455). Information covering the Random House sales for the three months ended March 31, 1970 which the defendant possessed prior to April 10, 1970, was material because it demonstrated (a) the lack of market acceptability of the Company's trade books during the 1969 Christmas season; (b) in six months, Random House cash advances to the Company had more than doubled to approximately $498,000; and (c) the Company's sales would not be sufficient to permit repayment of the Random House cash advances made by the Company (A.408-10, 455-57; Ex.1, pp. 1-2, E.1-2; Ex.8, E.132; Ex. B, p. 3, E.139, 141).

ARGUMENT

I. DEFENDANT FAILED TO SUSTAIN HIS BURDEN OF PROOF THAT HE COULD NOT HAVE KNOWN, HAD HE EXERCISED REASONABLE CARE, OF THE OMISSION OF MATERIAL INFORMATION (SECTION 12(2) OF THE SECURITIES ACT OF 1933)

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2) states:

"Any person who--

* * *

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

The trial judge devoted but two brief paragraphs of his opinion to the disposition of plaintiff's Section 12(2) claim as follows (A.49):

"Plaintiff alleges that defendant violated Section 12 of the Securities Act of 1933, 15 U.S.C. § 77l, by an omission to state material facts about the financial affairs of Chelsea House.

> "On this issue, defendant has the burden of proving lack of scienter. Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). Defendant has sustained his burden of proof that he exercised reasonable care to avoid any omission of material fact which could have caused plaintiff to be mislead."

The elements of a claim under Section 12(2) are well-established in this Circuit and elsewhere. Plaintiff need only prove that: (a) the defendant made an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading; and (b) plaintiff did not have actual knowledge of such untruth or omission. Hill York Corp. v. American International Franchises,Inc., 448 F.2d 680 (5th Cir. 1971); Murphy v. Cady, 30 F. Supp. 466 (D. Me. 1939), aff'd, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940); Thiele v. Shields, 131 F. Supp. 416, 419-20 (S.D.N.Y. 1955). As Judge Kaufman stated in Thiele v. Shields, supra, (131 F. Supp. at 419):

> "Secondly, the potential civil liability for misrepresentations under Section 12(2) appears to be much broader than that implied from Section 17(a)(2). All that a plaintiff-purchaser need prove under Section 12(2) is that a statement in a prospectus or oral communication is in fact false or is a misleading omission, and that he did not know of such untruth or omission."

Plaintiff is not required to prove scienter on the part of the defendant. Hill York Corp. v. American International Franchises, Inc., supra, (448 F.2d at p.695); The Johns Hopkins University v. Hutton, 422 F.2d 1124, 1128-30 (4th Cir. 1970); Gould v. Tricon, Inc., 272 F. Supp. 385, 392-93 (S.D.N.Y. 1967) (Tenney, J.). Nor is plaintiff required to show that he relied in any way upon the alleged misrepresentations or omissions. Hill York Corp. v. American International Franchises, Inc., supra, (448 F.2d at 695); The Johns Hopkins University v. Hutton, supra, (422 F.2d at 1129). As this Circuit held in DeMarco v. Edens, 390 F.2d 836, 841 (1968):

> "We also note our agreement with the district court's rejection of appellees' argument, that, as the offering circulars to which the omission in question were ascribed were not received by the appellants until their confirmations of sale were received (i.e., after the sale had been completed), the sale was not 'by means' of the circular. Were we to support appellees' contention we would, in effect, be erroneously introducing an element of reliance into the construction of Section 12(2)." (Citations omitted)

Alternatively, plaintiff is not required to prove causation or to demonstrate any casual nexus between his purchase or securities and the misrepresentation or omission of which he lacked knowledge. Hill York Corp. v. American

International Franchises, Inc., supra, (448 F.2d at 696); The Johns Hopkins University v. Hutton, supra, (422 F.2d at 1129-30).

1. Plaintiff Sustained His Burden of Proof

It is respectfully submitted that plaintiff sustained his burden in the court below. First, the trial court specifically found that the information which was not disclosed was material (A.41-42):

> "Plaintiff details several allegedly material facts contained in the March 1970 memorandum [Ex.1] which he contends were never disclosed. These are as follows [Ex.1]:
>
> "1) When the 'Buck Rogers' book was planned, no one realized that it could not make a profit until it sold 25,000 copies. This fact was only discovered after the book was published and in the book stores. [E.2)
>
> "2) The publicity department at Chelsea House ran costly ads in the newspapers when the books which were the subject of those ads were not in the stores. [E.2]
>
> "3) Books were added to the Chelsea House book list that no one had seen, let alone read, and without any preliminary production and editorial costing. [E.2]
>
> "4) Management produced films without scripts, without school curricular orientation and largely without purchasers. [E.3]

"5) Bill Poten, the national sales manager of History Machine, the Company's most important asset, was totally inexperienced and without the educational background to handle that job [E.4-5], also had no prior experience in fiscal matters as demonstrated by his inability to approximate year-end earnings two months after the 1969 fiscal year ended. [E.6)

"6) With regard to the Company's financial situation, the Company was near the end of its credit with Random House and the banks, and the Company was forced to spend an inordinate amount of time deflecting various of its creditors. [E. 5-7]

"7) The Company was in a state of emergency with its current liabilities exceeding its current assets by $500,000 and bankruptcy was imminent." [E.1, 5] (Plaintiff's Post-Trial Memorandum of Law at 10-11)."

The trial court then held as follows (A.42):

"Virtually all of this information is material in nature when viewed together. While no one piece of information was per se critical, each being no more than a mere detail, the total was of a quality that would guide a potential purchaser's approach to a transaction."

Second, plaintiff established that he lacked actual knowledge of the undisclosed material information. All of the foregoing omissions were items discussed in the memorandum prepared by defendant on or about March 13, 1970 (Ex.1, E.1). Plaintiff testified, and defendant conceded, that neither the defendant nor anyone else had given a copy of the memorandum to plaintiff

and that plaintiff did not have actual knowledge of either the memorandum or the material information discussed in the memorandum (A.411-12, 423-24, 443, 447, 449, 462, 468-72, 197-99, 330-31). Indeed, if the court had found that plaintiff had actual knowledge of the aforesaid material information, there would have been no reason for the trial court's lengthy discussion of the elements of scienter, reliance and plaintiff's failure to exercise reasonable care with respect to plaintiff's claim under Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act (A.38-49). If plaintiff had such actual knowledge, all of plaintiff's claims would have been dismissed on that basis alone.

2. Defendant Failed to Sustain His Burden of Proving that He Exercised Reasonable Care

Thus, this Court must reverse the judgment below unless this Court agrees with the trial court's holding that defendant sustained his burden of proof ". . . that he exercised reasonable care to avoid any omission of material fact which could have caused plaintiff to be misled." (A.49).

The trial court's phrasing of the standard by which defendant's conduct is to be measured is improper on its face. As discussed above, plaintiff is not required to prove reliance or any causal relation between his purchase and the omitted

material information (pp. 17-18, supra). Thus, the trial court's inclusion of the phrase ". . . which could have caused plaintiff to be mislead" in its framing of the applicable rule indicates that the court relied upon an inappropriate standard as the basis of its decision. The judgment below should be reversed for this reason alone.

Moreover, it is not clear what standard the court did apply in holding that defendant sustained his burden of proof. In discussing the element of scienter with respect to Section 17(a) and Section 10(b), the court below held that plaintiff had failed to sustain his burden of proving that the defendant acted in a manner which exhibited a willful or reckless disregard for the truth (A.40) and concluded (A.40-41):

> "This Court is not called upon to evaluate defendant's behavior against the lower 'negligence' standard, and expressly declines to consider the question."

Nowhere in the opinion below does the trial judge disclose what facts or legal rules he did consider in reaching the conclusion with respect to the Section 12(2) claim that the defendant had sustained his burden of proving that he could not have known of the omission of material information if he had exercised reasonable care.

Unless defendant's burden under Section 12(2) is to

be rendered meaningless, that burden must at least require that the defendant demonstrate that he made some effort to learn whether all material information had been communicated to the purchasers of his securities. The defendant's obligation under Section 12(2) is illusory if he can sustain that burden upon the bare assertion that he assumed that the purchasers had actual knowledge because they had access to the information or the defendant assumed that the purchasers had acquired such knowledge from a third party. Reasonable care required, at least, that defendant cause a copy of his memorandum to be delivered to each of the purchasers of his stock.

The trial court's finding that defendant exercised reasonable care to avoid the omission of material information cannot be sustained because defendant conceded that he took no action whatsoever to determine whether plaintiff and the other outside purchasers had been advised of all material information concerning the Company (A.411-12, 423-24, 443, 447, 449, 462, 468-72). Defendant was represented by counsel (A.446, 137), but he did not ask his attorney to ascertain whether the purchasers had received all material information (A.449).

Up to the date of his purchase, plaintiff was continually advised that all was going well with the Company and that the Company would be profitable for fiscal 1970 (A.511-12, 290-91,

198, 202, 228-29). Defendant knew that the plaintiff was not involved in the day-to-day operations of the Company (A.391-92, 412). He also knew or should have known that the plaintiff was not aware of the deteriorating condition of the Company by virtue of the fact that defendant knew that the other members of management were making extremely optimistic statements about the future prospects of the Company during the period immediately prior to the sale (A.437-38).

Defendant conceded that he did not give plaintiff a copy of his memorandum (Ex.1, E.1) which discussed the information which the trial court found to be material (A.411-12, 41-42; pp. 19-20, supra). Defendant conceded that he did not know and made no effort to learn whether plaintiff had received the memorandum or learned the information discussed therein from any other source. Defendant weakly claims that he assumed that plaintiff's associate Anderson had read the memorandum (A.411-12) but Anderson testified unequivocally that he had not even learned of the existence of the memorandum until after the Company filed its petition pursuant to Chapter XI in July 1970 (A.142-43).

In fact, defendant and his counsel were either unaware of defendant's obligation to make complete disclosure or deliberately chose to ignore defendant's obligation.

Defendant admitted that plaintiff did not attend any of the management meetings (A.391-92) and conceded that defendant was not aware of the extent of plaintiff's knowledge of material information concerning the financial condition and business operations of the Company (A.468-72). Nevertheless, defendant made no effort to insure that plaintiff was fully acquainted with these matters before selling plaintiff a part of his stock.

The recent decision of this Court in Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930 (2nd Cir. 1975), compels reversal in the present case. In Ross the trial court dismissed MGM's claim for rescission on the ground that "MGM should have known and Jerry and Arthur Ross might reasonably have assumed MGM to know" the material information which MGM alleged had not been disclosed to it. This Court reversed holding that (p.933):

> "Rule 10b-5 . . . required the Ross brothers to state all material facts necessary to make other statements not misleading . . . [citation omitted]. Such a duty is not discharged merely by giving the purchaser access to Company records and letting him piece together the material facts if he can. . . . [citations omitted]."

In the present case, the argument for reversal is even more compelling. If the defendants in Ross failed to satisfy their duty under Rule 10b-5 where the purchaser has a duty of reasonable inquiry, the defendant's silence in the present case

clearly failed to satisfy his statutory obligation to exercise reasonable care to avoid the omission to disclose material information. Plaintiff's lack of actual knowledge coupled with defendant's admission that he did not know, and made no effort to learn, the extent of plaintiff's knowledge of material information concerning the Company requires that the Court reverse the judgment below. An affirmance in the present case will subvert the congressional intent in adopting Section 12 to convert the ancient maxim of caveat emptor to a requirement that the seller also beware, that he not sell securities without making full disclosure to the purchaser. Wilko v. Swan, 346 U.S. 427, 430 (1953).

II. THE AWARD OF ATTORNEY'S FEES TO DEFENDANT IS VIOLATIVE OF THE POLICIES UNDERLYING THE FEDERAL SECURITIES LAWS

Defendant counterclaimed to recover on the two promissory notes, each in the amount of $16,926 which plaintiff delivered to defendant representing the balance of the purchase price for the stock (Ex.I, E.230). In addition to principal and interest, defendant sought an award of attorney's fees based upon the following provision in the two notes (Ex.I, p. 2, E.231):

> "If this note is placed with an attorney for collection, the maker shall pay all costs

> of collection, including, but not limited to, counsel fees, which fees shall be added to the unpaid balance of this note and be recoverable with and as a part thereof."

On the basis of this provision, the trial judge awarded defendant the sum of $12,850 for attorneys' fees and costs. The precise amount of each is not set forth in the court's opinion (A.52).

It is respectfully submitted that the language of the notes does not support the award and in addition the award of such fees will act as a deterrent to the assertion of rights under the federal securities laws.

In the present action, defendant was not required to incur attorneys' fees for collection purposes but rather to defend against the alleged securities law violation. It has been held that language similar to that in the notes in this case may not be the basis for attorneys' fees incurred in the defense of a securities law violation. In Sackett v. Beaman, 399 F.2d 884 (9th Cir. 1968), a purchaser of stock sought to rescind the purchase agreement on the basis of certain violations of the federal securities laws including Section 10(b) and Rule 10b-5. The plaintiff had paid the defendant a portion of the purchase price and the balance was represented by notes. According to the terms of the contract and the notes, a reasonable attorney's fee was to be allowed in the event of default requiring the defendant to place the note with an attorney for collection.

The attorney for the defendant moved for a reasonable attorney's fee pursuant to the note provision. Although defendant had successfully defended against plaintiff's claim for rescission, the court denied the motion, stating (399 F.2d at pp. 892-93):

> "Counsel's asserted entitlement to such a fee is based upon a provision in the 1961 contract for sale of the stock, and in the promissory notes. Under the contract provision, in the event of breaches and defaults in that agreement by Sackett, Beaman had the right to collect the notes and Sackett was required to pay Beaman any and all reasonable attorneys' fees 'by reason that [sic] suits are instituted on behalf of first parties [Beaman] to collect upon said notes.' The two promissory notes in question contained essentially similar provisions.
>
> "The case before us is not a suit instituted by Beaman to collect upon the notes. The provision of the contract and notes, relied upon by Beaman, do not expressly cover the matter of attorneys' fees in defending against an action to recover damages by reason of asserted violations of federal statutes. We are unwilling to so extend them, by implication, to cover such a suit as this. The motion is therefore denied."

The foregoing reasoning applies to the case at bar. It is clear that the contractual provision relied upon by defendant in support of his claim for attorneys' fees was intended by the parties to apply only to the situation where it was necessary for defendant to refer the plaintiff's notes to an attorney for collection because the plaintiff refused to pay said notes when due, not on the basis of any legal

dispute, but rather because plaintiff arbitrarily refused to pay such notes when they became due or was financially unable to do so.

In any event, even if the language in the promissory notes is deemed broad enough to cover the situation of a counterclaim posed as part of a defense to a securities law violation, the granting of attorneys' fees should be limited to the efforts expended in collecting the notes. The overwhelming majority of the defendant's attorneys' time was spent defending the alleged securities law violation. The matter of attorneys' fees should therefore be remanded to the district court to make such an apportionment.

Insofar as the attorneys' fees sought by defendant are attributable to his defense of plaintiff's action for rescission under Section 12(2) of the 1933 Act, the award by the trial court should be reversed because it is contrary to the clearly expressed congressional intent found in Section 11(e) of the 1933 Act, 15 U.S.C. 77k(e) which provides in part:

> "In any suit under this or any other section of this subchapter the court may, in its discretion . . . if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant . . . if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit."

This Court has recently held that attorney's fees may not be recovered under the 1933 Act unless the claim borders on the frivolous or is brought in bad faith. In Aid Auto Stores, Inc. v. Cannon, Current CCH Fed.Sec.L.Rep. ¶95,247 (2d Cir. July 23, 1975), this Court reversed the trial court's award of attorney's fees to the defendant in a case in which the judge directed a verdict at the close of plaintiff's case. The Court said that "Mere failure of a party to present sufficient evidence to support its claims will not in itself warrant a determination of frivolity." Id. at p. 98,277. In the present case, in no sense can it be said that the plaintiff's claim bordered on the frivolous. Instead, there was a closely fought battle on the determination of liability.

Moreover, appellate courts have uniformly refused to sustain an award of attorney's fees under Section 11(e) where the trial court has failed to make findings of fact and conclusions of law as to the lack of merit of the claim. Klein v. Shields & Company, 470 F.2d 1344,1347 (2d Cir. 1972); Oil & Gas Income, Inc. v. Woods Exploration and Producing Co., 362 F.2d 309 (5th Cir. 1966); Can-Am Petroleum Co. v. Beck, 331 F.2d 371,374 (10th Cir. 1964). As the trial court in this case has made no such findings of fact nor stated any conclusions of law regarding the merits of the claim, the granting of attorneys' fees must be remanded to the trial court for such findings and conclusions.

It is respectfully submitted that the rule governing the award of attorney's fees in an action arising under the securities laws should be uniform and the result should not turn upon the happenstance that a particular purchase of stock involves instalment payments. A plaintiff should not be discouraged from asserting legitimate substantial questions under the anti-fraud provisions of the securities laws by the fear that attorney's fees will be awarded against him if he fails to sustain his claim. The rule enunciated by Congress in Section 11(e) should be applied to the situation where there is a counterclaim based upon promissory notes containing a provision for the award of attorney's fees. If the plaintiff's claim is frivolous and merely designed to delay the payment of the notes, then attorney's fees should be awarded. On the other hand, as in this case, where the claims presented are of a substantial nature, the defendant should not be awarded attorney's fees, because in such a case his legal expenses are attributable to defending the securities laws claims, and not to collecting a note.

CONCLUSION

For each of the foregoing reasons plaintiff respectfully requests that the judgment below be reversed and that judgment be entered in favor of plaintiff granting rescission of the stock purchase agreement dated April 10, 1970 and

awarding judgment in favor of plaintiff for all principal and interest payments made by plaintiff to defendant pursuant to said agreement. Alternatively, if the judgment below is affirmed as to plaintiff's liability on the defendant's counterclaim for principal and interest on the promissory notes, plaintiff respectfully requests that so much of the judgment below as awarded attorneys' fees be remanded to the District Court with instructions to apportion the amount of attorneys' fees attributable to defense of the plaintiff's claim for rescission and the amount attributable to enforcement of the promissory notes and that the District Court be further instructed to award attorneys' fees to defendant only in the amount attributable to enforcement of the notes.

Dated: New York, New York
November 3, 1975

Respectfully submitted,

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